

**Report on the
Small Business Administration's**

**SUPPLEMENTAL TERRORIST ACTIVITY RELIEF
LOAN PROGRAM**

**From the Majority Staff of the United States Senate
Committee on Small Business & Entrepreneurship
September 6, 2006**

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PREFACE

In December 2001 Congress approved legislation, later signed into law by the President, that created, among other items, a loan program intended to assist small businesses affected by the tragic events of September 11, 2001 and their aftermath. The Supplemental Terrorist Activity Relief (STAR) loan program sought to provide loans to businesses nationwide that were “adversely affected” by the terrorist attacks and could not obtain adequate financing elsewhere. Prior to the attacks, the Small Business Administration (SBA) already administered a program to provide loans to small businesses nationwide that were unable to obtain adequate financing elsewhere. The only differences between the STAR program and this pre-existing program were that STAR borrowers were identified as those businesses that had been adversely affected by the September 11 attacks, and lenders paid a lower fee to the government to make STAR loans. There were 7,058 STAR loans made during the program’s 12 month existence, for a total volume of approximately \$3.7 billion.

The STAR program was administered by the SBA. It was structured to benefit affected businesses throughout the nation, and was not restricted only to those businesses located in the New York and Washington metropolitan areas.

The Senate Committee on Small Business and Entrepreneurship has the responsibility to oversee the SBA and to encourage the Agency to fulfill its role as a vital resource to this country’s 25 million small businesses. As the foundation of our economy, these small businesses deserve the unwavering support of the SBA and of the country.

As stewards of taxpayers funds, government agencies, such as the SBA, are expected to administer programs with competency and efficiency, and to ensure that participants in those programs adhere to a system of reasonable rules and regulations. When agencies fail to do so, it is Congress’s responsibility to maintain the checks and balances that our founders set in place. The Committee is firmly committed to its oversight responsibility, and the following report is an extension of the Committee’s duties.

2. Summary of Committee Report

On January 10, 2002, in the wake of the terrorist attacks of September 11, 2001, the President signed into law an Emergency Supplemental Act, previously approved by Congress,¹ which appropriated \$40 billion in response to the attacks. Among many other items, that Act appropriated \$75 million to the Small Business Administration (SBA) to subsidize loans to small businesses that were “adversely affected” by the September 11 attacks and their aftermath. The SBA made the loans as a variation of the SBA’s already-existing Section 7(a) loan program, and the SBA named the new program the Supplemental Terrorist Activity Relief (STAR) loan program. The program was administered from January 2002 to January 2003, and 7,058 STAR loans were made for a total volume of approximately \$3.7 billion.

Beginning in September 2005, at the request of Senator Olympia J. Snowe, the current Chair of the Senate Committee on Small Business and Entrepreneurship, the SBA’s Office of the Inspector General (IG) conducted an audit of the STAR program to gauge the validity of media reports that began in that month and alleged that STAR program loans had been made to borrowers that were not eligible. The objective of the audit was to determine whether STAR loan recipients were appropriately qualified to receive STAR loans and whether the SBA established and implemented proper administrative procedures to verify STAR loan recipient eligibility. The IG issued its findings on December 23, 2005.²

The IG reviewed 59 borrower loan files. According to the IG’s report, eligibility for most STAR recipients was difficult to ascertain based on the lender loan files it examined, and ultimately could not be determined for 85 percent of the loan files reviewed by the IG.

Concurrently, Chair Snowe also instructed the Committee’s staff to conduct an examination of the STAR program.

The Committee staff’s review was conducted with the purposes of (a) examining lender documentation used to determine borrower eligibility for the program; (b) assessing borrowers’ eligibility; (c) examining the SBA’s administrative procedures to determine if the procedures were adequate or flawed; and (d) analyzing whether these above matters were in accord with Congressional guidance and intent. Items (a), (b), and (c) had also been analyzed by the IG. The Committee staff’s review of items (a) and (b) were to determine whether results would be found different from the IG’s findings.

¹The full name of the act is Emergency Supplemental Appropriations for Recovery and Response to Terrorist Attacks on the United States, 2002 P.L. 107-117 (the Emergency Supplemental).

²Audit by the Office of the Inspector General of the Small Business Administration on the SBA’s Administration of the Supplemental Terrorist Activity Relief (STAR) Loan Program; Issue Date: December 23, 2005; Audit Report Number 6-09 (Appendix A)

During the review, Committee staff examined 66 STAR loan files from 27 lenders. The staff reviewed SBA documentation, lender documentation, and borrower documentation.

The following report is the result of an examination and analysis of the SBA's STAR loan program. This review was conducted independently by the Majority staff at the direction of the Chair. No part of this report was compiled by the SBA, the SBA's Office of the Inspector General, or any other organization, office, or Member of Congress.

3. The SBA's Section 7(a) loan program

Overview

Administered by the SBA's Office of Capital Access (OCA), the 7(a) Loan Guaranty program includes guarantees issued by the SBA for short- and long-term loans made by lending institutions to eligible, credit-worthy start-up and existing small businesses that cannot obtain financing on reasonable terms through normal lending channels.³ The guaranty program is offered through private lenders that are often referred to by the SBA as "participating lenders." There are three principal types of participants in the 7(a) Guaranty process: the small business borrower, the participating lender, and the SBA.

Eligibility Criteria

To qualify for an SBA guaranty, a small business must meet the 7(a) criteria and the lender must certify that it could not provide funding to the small business on reasonable terms without an SBA guaranty.

The eligibility requirements are designed to be as broad as possible so that the lending programs can accommodate a diverse variety of small business financing needs. Some criteria are applicable to all businesses. All businesses seeking a 7(a) loan must:

- Meet SBA size standards,
- Be a for-profit business,
- Not have the internal resources (business or personal) to provide the financing, and
- Demonstrate an ability to repay the loan.

Loans under the program are available for most business purposes, including purchasing real estate, machinery, equipment, and inventory, or for working capital.

Guaranty Levels

Under Section 7(a) loan regulations, the maximum total loan size is \$2 million, but the SBA can guarantee a maximum of \$1 million per 7(a) loan. The maximum SBA guaranty rate per loan is

³The program derives its name from the location of its statutory provisions, which are in Section 7(a) of the Small Business Act. (15 USC 636)

85 percent for loans of \$150,000 or less, 75 percent for loans greater than \$150,000; 90 percent for loans made under the Export Working Capital Program (EWCP); and 50 percent for loans made under the SBA Express program. Borrowers can have more than one loan at a time, as long as the total amount guaranteed does not exceed the SBA's guaranty cap of \$1 million.

Loan Fees & Interest Rates

To offset the costs of the SBA's loan programs to the taxpayer, the agency charges lenders a guaranty fee and a servicing fee for each loan approved. These fees may be passed on to the borrower once they have been paid by the lender. The amounts of the fees are determined by the amount of the loan guaranty and estimated costs of the program during that year.

For loans of \$150,000 or less, the guaranty fee is 1 percent of the guaranteed portion. Lenders may retain 25 percent of this guaranty fee (25 basis points). For loans of more than \$150,000 but less than or equal to \$700,000, the SBA charges a 2.5 percent guaranty fee. For loans greater than \$700,000, the guaranty fee is 3.5 percent. All loans are also subject to a 0.25 percent (25 basis points) annualized servicing fee, which is applied to the outstanding balance of SBA's guaranteed portion of the loan.

Interest rates for 7(a) loans may be fixed or variable. The rates are negotiated between each borrower and lender, but they are subject to SBA-established maximum rates.

4. The Origin of the STAR Program

The STAR program originated in emergency legislation enacted on January 10, 2002. That Act, among many other items, provided that the SBA should reduce the fees paid by lenders for loans made under the 7(a) program from 0.50 percent (50 basis points) of the outstanding balance of the guaranteed portion of the loan to 0.25 percent (25 basis points) if the borrowers had been "adversely affected" by the September 11, 2001 terrorist attacks.⁴ The SBA delegated to its participating lenders discretion to assess the eligibility of individual borrowers, and informed lenders that the lenders would have to document that assessment but need not submit it to the SBA.⁵ In addition to existing small business owners that had experienced difficulty in maintaining normal business operations, start-up small businesses that had planned to begin operating, but were impeded from doing so due to the attacks, could also qualify for the program.⁶ The STAR program was not limited to businesses located in the New York and

⁴ **P.L. 107-117, : The entire relevant text of the Emergency Supplemental was: "Sec. 203** Notwithstanding any other provision of law, the limitation on the total amount of loans under section 7(b) of the Small Business Act (15 U.S.C. 636(b)) outstanding and committed to a borrower in the disaster areas declared in response to the September 11, 2001, terrorist attacks shall be increased to \$10,000,000 and the Administrator shall, in lieu of the fee collected under section 7(a)(23)(A) of the Small Business Act (15 U.S.C. 636(a)(23)(A)), collect an annual fee of 0.25 percent of the outstanding balance of deferred participation loans made under section 7(a) to small businesses adversely affected by the September 11, 2001, terrorist attacks and their aftermath, for a period of 1 year following the date of enactment and to the extent the costs of such reduced fees are offset by appropriations provided by this Act."

⁵ SBA Procedural Notice 5000-779- 1/31/2002 stated, "Documentation must be available for review by SBA, but need not be submitted to SBA." (Appendix B)

⁶ SBA Procedural Notice 5000-779- 1/31/2002 (Appendix B)

Washington metropolitan areas, but was intentionally structured to benefit businesses across the country.

FIGURE 1.
Fee Comparison: Standard 7(a) loans vs. STAR loans

Fees	Fees in Regular 7(a) Program From Jan 11, 2002 through Sep. 30, 2002 (overlap with first 8.5 months of STAR program)	Fees in STAR Program Jan. 11, 2002-Sep. 30, 2002	Fees in Regular 7(a) Program Beginning Oct. 1 2002 (overlap with last 3.5 months of STAR program)	Fees in STAR Program Oct. 1, 2002-Jan. 10, 2003
Loans up to \$150,000 (Charged to lender, may be passed on to borrower)	2.0 %	2.0 %	1.0 %	1.0 %
Loans of \$150,001-\$250,000 (Charged to lender, may be passed on to borrower)	3.0 %	3.0 %	2.5 %	2.5 %
Loans of \$250,001-\$700,000 (Charged to lender, may be passed on to borrower)	3.0 %	3.0 %	2.5 %	2.5 %
Loans of \$700,001-\$2 million (Charged to lender, may be passed on to borrower)	3.5 %	3.5 %	3.5 %	3.5 %
Annual Fees (Charged to lender, may NOT be passed on to borrower)	0.50 %	0.25 %	0.25 %	0.25 %
Maximum Loan Size	\$2 million	\$2 million	\$500,000	\$2 million

Prior to passage of the Emergency Supplemental Act of 2002, SBA staff stated that they consulted with the staff of the Senate Committee on Small Business and Entrepreneurship and

that in those discussions there were not disagreements about the basic elements of the STAR program.⁷

5. Background Information on Budget Issues Surrounding the Section 7(a) and STAR Loan Programs:

To gain a full understanding of the STAR program, it is necessary to understand the history of the SBA budget plans and proposals that immediately preceded the creation and implementation of the STAR program.

On August 21, 2001, the Government Accountability Office (GAO), then called the General Accounting Office, issued a report that found the SBA's subsidy rate estimates for the 7(a) program between 1992 and 2000 were inaccurate.⁸ The SBA had drastically over-estimated the necessary subsidy rates and thus the costs of the program. As a result of these over-estimations, the subsidy rates during that time period were higher than necessary and the cost for lenders to provide standard 7(a) loans was nearly double what was necessary, given the actual economic performance of the program.

Chronology of 7(a) Subsidy Rates

1992-2000

Between 1992 and 2000, the SBA over-estimated defaults by over \$2 billion, or about 87 percent, when compared to actual loan performance. The SBA also originally over-estimated recoveries for 1992 through 2000 by nearly \$450 million, or about 62 percent, when compared to actual loan performance.⁹

Oct. 1999-Sept. 2000

From October 1999 through September 2000 (Fiscal Year (FY) 2000), the 7(a) program made 30,196 loans for a total dollar volume of \$9.7 billion. The original subsidy rate was 1.16 percent. The SBA re-estimated the rate to be 0.54 percent, less than half of the original estimate.

Oct. 2000-Sept. 2001

From October 2000 through September 30, 2001 (FY 2001), the 7(a) program made 30,562 loans for a total dollar volume of \$9.1 billion. The original subsidy rate was 1.16

⁷Committee staff met with SBA staff in March 2006 at the main office of the Committee to review several issues pertaining to the STAR program and the Committee's review of the program.

⁸Government Accountability Office Report- GAO-01-1095R *SBA's 7(a) Credit Subsidy Estimates* (Appendix D)

⁹Government Accountability Office Report- GAO-01-1095R *SBA's 7(a) Credit Subsidy Estimates* (Appendix D)

percent. The SBA re-estimated the rate to be 0.47 percent, less than half of the original estimate.¹⁰

Aug. 2001

GAO released report on the subsidy rates for the 7(a) loan program.

Sept. 2001

On September 7, 2001, Senator Kerry and Senator Bond, the then-Chair and Ranking Member of the Senate Committee on Small Business and Entrepreneurship, sent a letter to the Director of the Office of Management and Budget (OMB). The letter noted that since 1992, the SBA had over-estimated the costs of the 7(a) program, leading to inaccurate credit subsidy rates and subsequently, unnecessarily high fees for the lenders and borrowers participating in the program.¹¹

Four days later, the September 11 terrorist attacks occurred.

Oct. 2001

On October 4, 2001, Sen. Kerry introduced S.1499, which, among other items, attempted to amend the Small Business Act to authorize the SBA to make disaster loans to small businesses that were directly affected and suffered substantial economic injury as the result of the terrorist attacks of September 11, 2001.¹² This measure did not become law, but SBA procedural notices used by lenders as guidance for administering the STAR program were loosely based on S. 1499.

Oct. 2001-Sept. 2002

From October 2001 through September 30, 2002 (FY 2002), the 7(a) program made 38,239 loans for a total dollar volume of \$9.4 billion. The original subsidy rate was 1.07 percent. The SBA re-estimated the rate to be 0.31 percent, less than one-third of the original estimate.¹³

Dec. 2001

In December 2001, Congress approved legislation later enacted by the President (P.L.107-100) to reduce by 50 percent the fees in the 7(a) program starting on October 1, 2002. Once in effect, the reduced fees caused the subsidy rate to double (in order to maintain a zero subsidy program), which in turn caused the cost to lenders of providing 7(a) loans to increase.

¹⁰Office of Advocacy Performance and Accountability Report Fiscal Year 2003

¹¹Letter from the Chair and Ranking Member of the Senate Committee on Small Business and Entrepreneurship to the Director of the Office of Management and Budget- 9/7/2001 (Appendix E)

¹²American Small Business Emergency Relief and Recovery Act of 2001 (S.1499)

¹³Office of Advocacy Performance and Accountability Report Fiscal Year 2003

Jan. 2002

In January 2002, Congress passed the emergency supplemental that, among other items, provided \$75 million for special 7(a) loans for businesses “adversely affected” by the 9/11 attacks. The STAR program lasted from January 2002 through January 2003.

Oct. 2001-Sept. 2002

Between October 2001 and September of 2002 (FY 2002), the STAR program (which did not begin until January 2002) had a total dollar volume of \$1.8 billion (half of the total dollar volume of the program). Between October of 2002, which was the beginning of the two-year reduction in fees for 7(a) loans, and the end of the program in January of 2003, the STAR program also had a total dollar volume of approximately \$1.8 billion (half of the total dollar volume of the program).¹⁴

¹⁴Office of Advocacy Performance and Accountability Report Fiscal Year 2003

FIGURE 2.
STAR
CHRONOLOGY OF EVENTS

DATE	EVENT
August 2001	<i>GAO releases report on subsidy rates for the 7(a) loan program.</i>
September 2001	<i>9/11 terrorist attacks occur.</i>
October 2001	<i>Senator Kerry introduces bill (S. 1499) to allow small businesses affected by 9/11 to receive new type of 7(a) loan (difference from regular 7(a) loan is lower fees for lenders and separate appropriation). The bill passes the Senate on March 22, 2002, but never passes the House.</i>
December 2001	<i>P.L. 107-100, introduced by Senator Bond on July 18, 2001, is approved by the Senate and the House and signed into law by the President. As a result, fees in the 7(a) program are reduced by half effective on October 1, 2002.</i>
January 10, 2002	<i>P.L. 107-117 is enacted, containing \$75 million in appropriations for STAR. The STAR program began in January 2002, and new loans continued to be made until January 2003. S. 1499, introduced in October 2001, had not been approved by the Senate at the time the STAR program began.</i>
January 17, 2002	<i>SBA issues Procedural Notice 5000-775 detailing how lenders should implement the new program. The procedural notice hews roughly to the provisions of S. 1499.</i>
January 31, 2002	<i>SBA issues Procedural Notice 5000-779 naming the new program the Supplemental Terrorist Activity Relief (STAR) program.</i>
October 2002	<i>Regular 7(a) loans are capped at \$500,000, from \$2 million, while STAR loans continue to have a maximum size of \$2 million.</i>

Overlap of Budget Issues with the 7(a) and STAR Programs

In 2002, the SBA had underestimated the demand for standard (non-STAR) 7(a) loans and requested insufficient appropriations from Congress for FY 2003 (as it again did for FY 2004, leading to the shutdown of the program in January of 2004). As a result, the Agency implemented a loan cap of \$500,000 (one-fourth of the normal maximum loan size of \$2 million), effective on the first day of FY 2003 (October 1, 2002). STAR loans, however, were not effected by this loan cap because Congress had appropriated funds for the program separate from standard 7(a) appropriations. As a result, STAR loans could still be made up to the full \$2 million per loan. The impact of this disparity between STAR loans and standard 7(a) loans is even more notable considering that the fees in the standard 7(a) loan program were lowered to be

exactly the same as the fees in the STAR program, and this fee reduction became effective on the same day as the new loan cap.

As of October 1, 2002, the fees for issuing STAR loans and standard 7(a) loans were thus identical. From that date on, however, standard 7(a) loans could not be issued in amounts exceeding \$500,000 whereas STAR loans could be issued for amounts up to \$2 million.

Impact

\$1.8 billion in STAR loans (50 percent of the program's total volume) was approved in the first eight and a half months of the program (from January 2002 until the end of FY 2002, on September 30, 2003). Another \$1.8 billion in STAR loans (50 percent of the program's total volume) was approved over the next three and a half months, from October 1, 2002 until the STAR program ended in January of 2003.¹⁵ Thus, half of the STAR program's loan volume (in dollars) was made over a period representing 71 percent of the program's duration, and the other half of the program's volume was made during the last 29 percent of the program's duration.

Because of the dwindling funds available in the 7(a) program during FY 2002 and during the beginning of FY 2003, the STAR program became an alternate means of accessing additional funds for small business loans. As a result, lenders may have taken advantage of the higher loan caps by being more inclined to make loans as STAR loans than had previously been the case.

6. Congressional Intent – “Adversely Affected”

The SBA formulated broad guidelines for the lenders to interpret the definition of the phrase “adversely affected.” It is clear that the Agency wanted the STAR program to be utilized by lenders and borrowers across the country, and not just borrowers located in New York or Washington.¹⁶ According to SBA Procedural Notice 5000-779, a small business concern is:

“A small business that suffered economic harm or disruption of its business operations as a direct or indirect result of the terrorist attacks perpetrated against the United States on September 11, 2001... Agency guidance should not be construed as limiting eligibility to any particular geographic area or to any specific type(s) of business.”

The SBA provided a list of examples of economic harm in the notice, but added that it “does not intend that this list be considered all-inclusive.”¹⁷ The notice also allowed for the lenders to use their discretion when determining whether a business was adversely affected:

¹⁵The STAR Program never ran out of money, but instead ended after its appointed 12-month term without all of its money being allocated. If any STAR loan application was rejected it would have been because the borrower was not qualified, and not that the program was out of funds.

¹⁶Committee staff met with SBA staff in March 2006 at the main office of the Committee to discuss several issues containing to the STAR program and the Committee's review of the program.

¹⁷SBA Procedural Notice 5000-779- 1/31/2002 (Appendix B)

“Determine that the applicant business was ‘adversely affected’ by the terrorist activity of September 11, 2001, and document the basis for this conclusion in loan file. This documentation must be available for review by the SBA, but need not be submitted to the SBA.”

It is evident from statements made in the Congressional Record by Senator Kerry and Senator Bond, at that time the Chair and Ranking Member, respectively, of the Senate Committee on Small Business and Entrepreneurship, that they expected the interpretation of the phrase ‘adversely affected’ would be broad and widely inclusive.¹⁸

Senator Kerry:

“Small Businesses would be better served through a combination of disaster loans and government guaranteed loans...Our proposal combines public and private sector approaches to ensure small businesses nationwide receive the maximum amount of assistance.”

Senator Bond:

“Small businesses from across the United States are continuing to struggle under the dual pressures from the economy and the aftermath of the terrorist attacks.”

Senator Kyl, on the other hand, voiced his concerns over the potential for fraud under a program similar to the STAR program. In October 2001, Senator Kerry had introduced legislation, S. 1499, creating a program similar to the STAR program. Speaking about S. 1499, Senator Kyl stated the following:

“Additionally, S. 1499's language is so broad that loan assistance could be provided to any small business that have ‘been, or, that (are) likely to be directly or indirectly adversely affected’ by the terrorist attacks. Obviously, such language is ripe for abuse and could lead to exorbitant costs for the American taxpayer.”¹⁹

After the STAR program began, the SBA informed lenders that the Agency would not “second-guess” the lenders’ decisions as to which loan applicants had been adversely affected by the 9/11 attacks, or their aftermath. According to press reports, when speaking to a lender’s association in June 2002, the SBA Associate Administrator for Financial Assistance stated the following:

¹⁸Excerpts from the Congressional Record (Appendix E)

¹⁹Excerpts from the Congressional Record (Appendix E)

*“It is not our intent to substitute our judgement for your judgement in these cases. As a matter of fact, we believe that every business can probably demonstrate some degree of economic disadvantage as a result of the terrorist attacks of September 11.”*²⁰

7. SBA Inspector General’s Audit of the STAR Program

In the wake of media reports in September 2005 alleging mismanagement and abuse of the STAR program, Senator Snowe requested an audit by the SBA’s Office of the Inspector General. The purpose of the audit was to examine the program and assess the qualifications of STAR loan recipients and the procedures of the SBA’s management of the program.²¹ The audit report was released on December 23, 2005.

At the same time as the IG was conducting its audit, Committee staff began its own review of the program. Conducted separately and independently, the review by Committee staff yielded similar results to the report by the Inspector General on those issues that were covered by both reviews.

Key Findings of The Inspector General’s Audit

- **IG Conclusion:** Recipient eligibility for STAR loans could not be determined for 85 percent of the 59 STAR loans reviewed by the IG. The IG found that only 15 percent of the files it reviewed were “appropriately qualified to receive a STAR loan.” The other 85 percent of the files fell into one of five categories designated by the IG (see figure 3.).
- **IG Conclusion:** The STAR program contained “lack of adequate controls and oversight.” The IG determined that “STAR loans may have gone to businesses that were not adversely impacted by the terrorist attacks.”

Recommendations of the Inspector General

The IG included in its report several recommendations for the SBA. These recommendations were designed to provide guidance to the Administration for handling the STAR program as well as for future disaster loan program management. The IG recommended that the SBA:

²⁰Coleman Report, June 2002. “SBA Vows Not to Play ‘Gotcha’ for STAR Loans” (Appendix F)

²¹Audit by the Office of the Inspector General of the Small Business Administration on the SBA’s Administration of the Supplemental Terrorist Activity Relief (STAR) Loan Program; Issue Date: December 23, 2005; Audit Report Number 6-09 (Appendix A)

- *Require lenders to submit justifications when seeking to receive guarantee payments from the SBA for STAR loans that have defaulted.*
- *Determine whether apparent ineligible STAR loans should be reclassified as regular 7(a) loans.*
- *Review guarantees the SBA has already paid for defaulted STAR loans to determine if eligibility justifications were sufficient.*
- *Improve oversight for future disaster loan programs by requiring that documentation be submitted and reviewed by the SBA (rather than the lenders) thoroughly demonstrating each borrower's eligibility for the program.*

SBA Response to the Inspector General's Report

On February 1, 2006, SBA Administrator Hector Barreto provided a memo to Senator Snowe responding to the IG's report.²² The memo from the Administrator defends the Agency and the STAR program:

"Despite widespread press accounts there is no evidence of any widespread misuse or abuse of the STAR program. In particular, there is no basis for the claims that STAR in any way affected the availability of any form of disaster assistance to any small business directly affected by the terrorist attacks of 9/11. By its very nature, as a part of the 7(a) program, STAR was separate and distinct from the funding and purposes of the SBA's direct disaster loan assistance program. As the IG report made clear, and any objective assessment would include, no eligible business needing physical disaster, EIDL, or Expanded EIDL assistance was declined or denied assistance as a result of the STAR program.

As to the implementation of the STAR program itself, it was far from flawless. Despite the broad eligibility criteria, proper documentation by some of SBA's lending partners have not been included in the files and the SBA recognizes that we should have been more diligent in our oversight of the lending files. However, while not excusing the lack of clear documentation, the OIG still found no evidence of ineligible lending."

The STAR program was designed to benefit small businesses in need of financial relief as a result of the terrorist attacks of 9/11. The SBA's oversight responsibility included ensuring that STAR loan recipients were, in fact, the businesses the program was designed to help. Struggling small businesses unaffected by the 9/11 tragedy were not the targeted borrowers intended to benefit from the STAR program. In his response, Administrator Barreto acknowledged that there were flaws in the Agency's execution of its oversight responsibility regarding the STAR program.

8. Objectives and Scope of Committee Review:

²²Memorandum from SBA Administrator to the Chair of the Senate Committee on Small Business and Entrepreneurship, February 1, 2006 (Appendix C)

Preliminary Organization

At the direction of the Chair, Committee staff examined the origin, purpose, and implementation of the SBA's STAR Loan program. The Committee staff's review was conducted with the purposes of (a) examining lender documentation used to determine borrower eligibility for the program; (b) assessing borrowers' apparent eligibility; (c) examining the SBA's administrative procedures to determine if the procedures were adequate or flawed; and (d) analyzing whether these above matters were in accord with Congressional guidance and intent. Items (a), (b), and (c) had already been analyzed by the IG. In particular, the Committee staff's review of items (a) and (b) were merely to determine whether results different from those of the IG would be found.

Objectives and Scope

Committee staff examined a random sample of 66 STAR loan files from 27 participating lenders to review SBA documentation, lender documentation, and borrower documentation. The files were classified by Committee staff into three separate categories based upon the data and information found in the file:

- Sufficient Documentation (Class A- Sufficient)
- Questionable Documentation (Class B- Questionable)
- Insufficient Documentation (Class C- Insufficient)

The goal of this review was to examine the STAR program, from inception through completion. Committee staff examined the loan files in order to determine if the documentation and justifications were adequate but also, more broadly, to determine if STAR loans were properly issued to small businesses that qualified under the eligibility standards established for the program.

9. Findings of Committee Staff Review:

Review of Loan Files

Documentation: One of the objectives of the Committee staff's review was to determine if the participating lenders maintained clear, adequate documentation of borrowers' eligibility to receive a STAR loan. Committee staff reviewed the justifications provided by the lenders illustrating eligibility and detailing the adverse impacts of 9/11 on the borrowers.

According to procedural notices issued by the SBA to their participating lenders, documentation specifically citing and explaining justifications for STAR loan eligibility was required to be maintained by the lenders:

*“Each lender making a reduced fee 7(a) loan under the provisions of the new law is responsible for determining that the loan is being made to a small business that was adversely affected by the terrorist attacks of September 11, 2001. For each such loan, the lender must prepare, place, and keep in its loan file, a short written statement documenting the basis for its conclusion that the loan is eligible for inclusion under this provision.”*²³

This SBA procedural notice clearly required lenders to maintain proper documentation, and future procedural notices added that the SBA would not review the lender’s files or require the lenders to submit the documentation to the SBA.²⁴ SBA Procedural Notice 5000-779 states:

“The lender must...prepare and maintain in its loan file a write up summarizing its analysis and its conclusion that the loan is eligible for the STAR program. A lender will not be found to have met its responsibility for determining that a borrower was adversely affected if the lender statement merely states that conclusion, but does not provide a narrative justification demonstrating the basis for that conclusion.”

The lenders were required to retain records in the borrowers’ files supporting a clear connection between the 9/11 attacks and any adverse economic impact on the recipient small business as a result of that attack. Failure to do so by the lenders resulted in non-compliance with SBA guidelines. For example, one of the lender files reviewed by Committee staff contained this justification for STAR loan eligibility:

“Slowdown in business activity.”

In this example, there is no description of a correlation between the slowdown in business activity and the events of 9/11. The lender in the example did not retain documentation supporting a clear connection between 9/11 and the “slowdown” in business.

A loss in revenue or profits after 9/11 does not, in itself, demonstrate an adverse affect caused by 9/11. Similarly, borrowers who demonstrated increases in revenues or profits after 9/11 might still have suffered adverse affects from 9/11. There are many other intervening factors such as business management, business experience, and industry conditions that were specific to each individual loan recipient and could have affected normal business operations regardless of the events of 9/11.

Upon examination of lender files, Committee staff found that only 26 percent of the loan files reviewed contained adequate documentation demonstrating recipient eligibility to

²³SBA Procedural Notice 5000-775- 01/17/2002 (Appendix G)

²⁴SBA Procedural Notice 5000-779- 1/31/2002 (Appendix B)

receive a STAR loan. Of the files reviewed by Committee staff, 74 percent contained either questionable, inadequate, or no documentation.

Eligibility: Committee staff did not utilize “new” or external evidence to assess STAR loan recipients’ eligibility but rather considered the evidence in the files used by the lenders to justify use of the STAR program. SBA guidelines instructed the lenders to retain short, written statements explaining their justifications. However, because Committee staff’s review found that most lenders did not follow these guidelines, further examination of the information in the lenders’ files was necessary.

Committee staff inspected financial records to gauge the economic impact of September 11 on the borrowers after the attacks. Borrowers’ qualifications for the STAR program were studied regardless of whether the lenders’ files contained the required short statement by the lenders explaining their justifications for using the STAR program.

However, due to its broad structure, the STAR program was open to wide interpretation by the lenders regarding the proper borrower qualifications for eligibility to receive STAR loans. The lack of clear guidelines allowed lenders to justify making a STAR loan to almost any borrower.

Committee staff determined that almost any small business could have been found by the lenders to be eligible for a STAR loan due to the vague design of the program.

CLASS A- Sufficient

Some borrower files contained justifications that clearly supported the borrower had been adversely affected by the events of 9/11. Increases in revenue did not disqualify a borrower from being eligible for the STAR program. A borrower could still have been adversely affected by 9/11 despite experiencing an increase in revenue:

“Revenues since 9/11/01 have not increased as dramatically as they have in the past; (30% growth from 1999 to 2000; 40% growth from 2000 to 2001; only 12% from 2001 to 2002).”

This documented justification clearly indicates why the lender determined that this specific borrower was adversely affected by the terrorist attacks of 9/11 and thus, was eligible to receive a STAR loan. Committee staff classified this borrower as ‘Class A- Sufficient’ based on this documentation and additional documentation found in the file.

Lender files that contained sufficient documentation, including financial records, to indicate the adverse economic effects of 9/11 were grouped into this category by Committee staff. These borrowers were impacted financially by the attacks and were properly issued STAR loans, and the lenders maintained sufficient documentation to justify the use of the STAR

program. **Of the files examined by Committee staff, 26 percent were classified as CLASS A-Sufficient (Figure 3.).**

CLASS B- Questionable

In several cases, the lenders' justifications were vague and questionable. Although the STAR program was designed to benefit start-up business as well as existing businesses, proper justification was still a mandatory requirement of the lenders. This justification was found by Committee staff in one of the loan files:

"Delayed decision in starting a freighting type business due to the events of 9/11."

This justification was classified as "Class B- Questionable," since the STAR program was in fact designed to be available to start-up businesses as well as existing businesses. This justification, however, does not explain clearly enough specific reasons for the "delayed decision." Committee staff was unable to determine this borrower's level of eligibility based upon the justification provided, as well as all other documentation contained in the loan file.

A borrower located in California was issued a STAR loan based on a drop in business activity after 9/11:

"General construction activity fell sharply as a result of the general decline in consumer and business confidence following 9/11."

The financial records in the file indicate an increase in sales each year from 1999-2002. The file did note that sales dropped 5 percent after 9/11, however sales had picked up 17 percent in the first half of FY 2002 prior to being approved for a STAR loan. Based on the information in this file, Committee staff was unable to definitively and specifically determine that the borrower had been adversely affected by the 9/11 attacks. **Of the files examined by Committee staff, 27 percent were classified as CLASS B- Questionable (Figure 3.).**

CLASS C- Insufficient

Some files indicate that the loan is a STAR loan but provide no justification for that conclusion. Or, the files offer generic statements regarding all businesses and the United States economy as a whole after September 11, 2001. Some of the justifications simply stated that every business was "adversely affected" by the attacks of 9/11, hence every business qualifies for a STAR loan:

"This loan will be funded as a S.T.A.R. loan under the PLP program. Any small business that has suffered economic harm or disruption of its business operations as a direct or indirect result of the terrorist attacks perpetrated against the United States on September


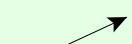




11, 2001 is eligible under the S.T.A.R. program. The lender is then permitted to pay the on-going guarantee fee of 0.25% instead of 0.50% of the guaranteed portion.”

Without offering detailed information specific to the borrower, Committee staff was unable to consider the documentation acceptable and classified such loans as “Class C- Insufficient.” **47 percent of the files examined by Committee staff were classified as CLASS C- Insufficient (Figure 3.).**

No Justification Provided and No Eligibility Determined

Committee staff found that 9 percent of the loans reviewed contained absolutely no documentation or justification of borrowers’ eligibility and no reference to the STAR program anywhere in the file (classified as part of the ‘Class C-Insufficient’ category). It is unclear why these loans were classified by lenders and by the SBA as STAR loans.

Figure 3.
Committee Staff's Classification of Loan Files

Committee Staff Categorical Breakdown of Loan Files	Findings of Committee Staff	Committee Staff Classifications of IG's Categories into Broader Categories	IG Categorical Breakdown of Loan Files
CLASS A Sufficient Documentation	26%	15% 	<i>"Appropriately qualified to receive STAR loan" (15%)</i>
CLASS B Questionable Documentation	27%	34%  	<i>"Justification was based on the adverse effects suffered by the business being purchased with a STAR loan rather than the 'loan applicant' and SBA procedures did not specify whether such loans could qualify" (19%)</i>
			<i>"Justification was vague and neither contrary to nor supported by documentation in the lender's loan file or borrower statements" (15%)</i>
CLASS C Insufficient Documentation	47%	51%   	<i>"Justification was missing" (8%)</i>
			<i>"Justification was merely a conclusion with no support" (7%)</i>
			<i>"Justification was contrary to documentation in the lender's loan file or borrower statements" (36%)</i>

Correspondence with STAR Loan Recipients

According to the IG's report, most STAR loan recipients were unaware that they received a loan designed to benefit small businesses after the September 11 terrorist attacks:

*"Only two of the 42 borrowers [contacted] were aware they had obtained a STAR loan. Thirty-six of the 42 borrowers [contacted] said they were not asked or could not recall if they were asked about the impact of the attacks on their businesses."*²⁵

Committee staff also contacted STAR loan recipients and did not determine that any borrowers were aware the loans they received were related to the terrorist attacks.

Without directly asking borrowers about the economic effects of 9/11 on their business operations, borrowers' qualifications to participate in the STAR program could not have been adequately and thoroughly determined.

The STAR program was designed to provide financial relief to small businesses in cases where adverse economic injury was linked to the 9/11 attacks. Many small businesses across the country sought financial assistance in various forms after the 9/11 attacks. There are, however, external factors unrelated to 9/11 that could have caused some small businesses to experience financial decline. Lender reviews that were only limited to borrowers' financial records were insufficient to effectively determine that small businesses were adversely affected by 9/11. In order to adequately determine borrowers' qualifications to receive STAR loans, lenders should have directly asked borrowers about the economic effects of 9/11 on business operations.

It was not determined by Committee staff that any small business intentionally took unfair advantage of the STAR program, nor was it determined that any small businesses unaffected by the events of 9/11 purposefully sought a STAR loan. **No small businesses were found by Committee staff to have deliberately misused the STAR program.**

10. Conclusions

According to SBA Administrator Hector Barreto, the SBA offered four levels of economic assistance to small businesses in the aftermath of the September 11, 2001 terrorist attacks:

- Direct physical disaster lending to businesses directly injured by the physical effects of the attacks.

²⁵The IG's statistical sample included 59 STAR loan borrowers, however the IG was only able to reach 42 borrowers out of their total sample for interviews.

- Direct Economic injury disaster lending (EIDL) to businesses at Ground Zero, businesses in the adjoining five boroughs in New York, and businesses in Northern Virginia due to the attack on the Pentagon.
- Expanded economic injury lending (EEIDL), available to businesses nationwide affected either by federal safety and security measures or a direct casual link to the 9/11 attacks.
- The STAR program.

The STAR program comprised the fourth and final level of assistance. The Administration has stated that the STAR program operated within the intent of Congress, and benefitted businesses nationwide in the wake of the attacks. The Agency has also acknowledged that its implementation of the program was “far from flawless,” but has contended that no ineligible lending occurred.²⁶

As previously stated, the AP alleged in September 2005 that the SBA, its participating lenders, and small business STAR loan recipients had engaged in widespread “abuse” of the program after 9/11. These reports cited examples of various small businesses across the country that had received STAR loans despite arguably being unaffected by the events of 9/11.

In reviewing the STAR program, Committee staff determined that various factors, including the vague design of the program, inadequate oversight by the SBA, and insufficient documentation on the part of the SBA and its participating lenders contributed to problems with the implementation of the program. Committee staff did not determine, however, that any small business STAR loan recipients abused or misused the STAR program.

After underestimating demand for standard 7(a) loans, and requesting insufficient appropriations from Congress for FY 2003, the SBA’s 7(a) loan program began to run out of money. As a result, the Agency imposed a loan cap of \$500,000, down from \$2 million, on all standard 7(a) loans effective on October 1, 2002. On the same day, as a result of a previous Congressional Act, the lender fees in the standard 7(a) program were reduced by half.

The STAR program, although a subset of the 7(a) program, had a separate appropriation and lower lender fees than the standard 7(a) program.

On October 1, 2002, the fees in the standard 7(a) program matched the fees in the STAR program. STAR loans, however, could still be made in amounts up to \$2 million while standard 7(a) loans could only be made in amounts up to \$500,000.

The STAR program had been in existence for almost nine months prior to October 1, 2002. After that date, the STAR program lasted just over three more months. Half of the total

²⁶Memorandum from SBA Administrator to the Chair of the Senate Committee on Small Business and Entrepreneurship, February 1, 2006 (Appendix C)

dollar volume of STAR loans was approved after October 1, 2002, during the final three and a half months of the program's duration, after the reduction-in-fees in the standard 7(a) program and the imposition of the \$500,000 loan cap on standard 7(a) loans became effective.

The STAR program became an alternate means of accessing funds after the standard 7(a) program became more burdensome to the lenders. Participating lenders had the ability to justify the use of a government guaranty loan program at their own discretion because of a lack of adequate oversight on the part of the SBA. Committee staff's review revealed that most lenders, 74 percent of those whose files were reviewed, did not properly administer the STAR program, in the sense that they did not maintain adequate documentation.

Committee staff also determined that the STAR program was designed with an extremely broad conception of eligibility and, as a result, evolved into an all-inclusive program. While the intent of Congress for this program was broad inclusion, the manner of the implementation of the program meant that conceivably every small business across the country became eligible to participate in the STAR program. Other levels of disaster assistance may have been more appropriate for some small businesses.

Committee staff concludes that vague guidance from Congress and a lack of specific guidelines from the SBA caused the STAR program to become all-inclusive, and also provided a path for lenders to circumvent the newly-implemented restrictions of the standard 7(a) program.